Supreme Court, U.S.
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No. 92-596

In The

Supreme Court of the United States

October Term, 1992

DR. SEYMOUR LICHT P.E.,

Petitioner,

v.

TEXAS COMMERCE BANK, N.A.,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Does a debt for debt face value exchange in a consensual out of court restructuring create unmatured interest, in the form of original issue discount, within the meaning of the Bankruptcy Code provision which disallows claims for unmatured interest?

LIST OF PARTIES

The undersigned counsel of record certifies that the following listed persons were parties to the proceeding in the court whose judgment is sought to be reviewed.

1. Class 5 Unsecured Creditors under Debtor's First Amended Plan of Reorganization.

2. Dr. Seymour Licht, Petitioner.

3. Richard H. Kuh and Warshaw, Burstein, Cohen, Schlesinger & Kuh, 555 Fifth Avenue, New York, New York 10017, attorneys for the Official Committee of Unsecured Creditors of Pengo Industries, Inc.

4. Holders of Class A and Class B Subordinated Guaranteed Debentures due December 1, 1991, of Pengo Industries, Inc.

5. Texas Commerce Bank, National Association, as Indenture Trustee, Respondent.

6. Edward L. Rothberg and Weycer, Kaplan, Pulaski & Zuber, P.C., 1400 Summit Tower, Eleven Greenway Plaza, Houston, Texas 77046, attorney for Respondent, Texas Commerce Bank, National Association.

Texas Commerce Bank, National Association's parent corporation is Texas Commerce Bancshares which is wholly owned by Chemical Banking Corporation. Texas Commerce Bank, National Association has no nonwholly owned subsidiaries.

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STATEMENT OF THE CASE

I. Procedural History

Dr. Seymour Licht's ("Licht") Petition for Writ of Certiorari in this matter arises from a bankruptcy case in which Licht is a holder of certain 8.5% debentures issued by the Chapter 11 Debtors, Pengo Finance, N.V. and Pengo Industries, Inc. ("Pengo"). Texas Commerce Bank, National Association ("TCBNA"), is the Indenture Trustee on behalf of the Holders of Class A and Class B debentures issued and guaranteed by Pengo. The full face amount of outstanding Class A and Class B debentures is $2,042,000 and $2,085,500 respectively.

TCBNA originally filed proofs of claim on behalf of the Class A and Class B Debenture Holders in Pengo's bankruptcy case representing 19,983 separate debentures with a face value of $500 each. (R. 63).[1] On October 2, 1989, Licht filed objections to the claims of the Class A and Class B Debenture Holders claiming that such debentures were sold at a discount which created unmatured interest which was not allowable under 11 U.S.C. Section 502(b)(2). (R. 1-16). The Official Committee of Unsecured Creditors ("Committee") joined in Licht's objection. (R. 31-47). After the parties stipulated to all of the essential facts, the Bankruptcy Court conducted an oral hearing and on December 28, 1989, sustained the objection of Licht and the Committee. (R. 420-27). The effect of this ruling was to reduce the claims of the Class A and Class B

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[1] References to the Record on Appeal will appear as (R. ___).

Debenture Holders to $1,411,812.35 and $1,522,626.40, respectively.[2] (R. 47).

On January 8, 1990, TCBNA timely filed a notice of appeal of the Bankruptcy Court's order to the District Court. (R. page unnumbered). All parties filed their appellate briefs, and on July 3, 1991, the District Court reversed the Bankruptcy Court's decision and reinstated the full face amount of the Class A and Class B Debenture Holder claims. (R. 529). On or about July 23, 1991, Licht timely filed a notice of appeal to the United States Court of Appeals for the Fifth Circuit. (R. 530).

On June 12, 1992, the United States Court of Appeals for the Fifth Circuit issued its opinion affirming the ruling of the District Court. Licht has filed a Petition for Writ of Certiorari seeking a review of the decision of the Fifth Circuit Court of Appeals.

II. Statement of Facts

In 1980, Pengo issued convertible debentures in $1,000 denominations bearing interest at the rate of 8.5% payable annually with principal coming due in 1995 (the "8.5% Debentures"). (See Stipulation of Facts contained in the joint record excerpts at tab 6, paragraph 9). The 8.5% debentures were sold to the public for the full face value

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[2] The amount of the claims was subsequently reduced by TCBNA to reflect representation of only 8,255 separate debentures with a face value of $500 each. Application of the formula used by the Bankruptcy Court in its decision results in setting the claims of Class A and Class B Debenture Holders at $1,388,355.88 and $1,417,931.40, respectively.

of $1,000 each. (*Id.* at paragraph 11). Since Pengo received the full face value for each 8.5% debenture, there was no discount which created additional or unmatured interest.[3]

Due to financial difficulties, Pengo was unable to make the interest payments due with respect to the 8.5% debentures for the years 1983 through 1987. (*Id.* at paragraph 12). Pursuant to an out of court workout consummated in 1984, Pengo offered to exchange each 8.5% debenture for a non-interest bearing Class A debenture in the principal amount of $500 and a non-interest bearing Class B debenture in the principal amount of $500 (*Id.* at paragraphs 14, 20). Thus, the 8.5% Debenture Holders who participated in the exchange received two (2) debentures with a total face value of $1,000 for each of their $1,000 8.5% debentures. (*Id.*). Hence, the Class A and Class B debentures were not issued at a discount.

The Debenture Holders who participated in this exchange waived the payment of past due interest. (*Id.* at paragraph 24). Further, Pengo gained an additional benefit because the new Class A and Class B debentures were non-interest bearing, allowing Pengo to accrue no interest expense with respect to the Class A and Class B debentures. (*Id.* at paragraph 21).

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[3] If the 8.5% debentures were sold for $900 each, the $100 discount would be considered additional interest over and above the 8.5% stated rate. Such discount interest would have accrued rateably over the life of the debentures.

REASONS FOR DENYING THE WRIT

I. The United States Court Of Appeals For The Fifth Circuit Was Correct In Holding That The Debt For Debt Face Value Exchange Involved In This Case Did Not Create Unmatured Interest In The Form Of Original Issue Discount

The Fifth Circuit Court of Appeals began its review and analysis of this case by noting that Section 502(b) of the Bankruptcy Code requires the Bankruptcy Court to disallow any claim for unmatured interest. *Texas Commerce Bank, N.A. v. Licht (In Re Pengo Industries, Inc.)*, 962 F.2d 543, 546 (5th Cir. 1992), *petition for cert. filed*, (No. 92-596, October Term 1992). The Court then noted that original issue discount ("OID"), which results from the issuance of a debt instrument for an amount less than its face value, does constitute unmatured interest. *Id.* (Citations omitted).

In affirming the District Court's decision, the Fifth Circuit relied on an opinion issued by the Second Circuit Court of Appeals in *LTV Corp. v. Valley Fidelity Bank & Trust Co. (In Re Chateaugay Corp.)*, 961 F.2d 378 (2nd Cir. 1992). In *Chateaugay*, the Second Circuit dealt with a fact situation in which the company exchanged new senior notes with a face value of $1,000 for old debentures with a face value of $1,000. *Id.* at 380. As in *Chateaugay*, the Pengo exchange offer constituted a face value exchange meaning that rather than issuing the Class A and Class B debentures at a discount creating unmatured interest "Pengo simply substituted 'new indebtedness for an existing debenture, modifying terms or conditions but not

reducing the principal amount of the debt.' " *Pengo* at 547. (Citations omitted).

As in *Chateaugay,* the Fifth Circuit Court of Appeals also relied on the importance of encouraging out of court workouts in bankruptcy cases. *Id.* at 549. The court noted that, "a rule that a debt for debt face value exchange in a consensual out of court workout creates OID concomitantly reduces the likelihood that creditors will 'cooperate with a struggling debtor' because such a rule lowers the exchanging creditors claims in bankruptcy." *Id.* The court then notes that such a policy would "surely translate into 'fewer out of court debt exchanges and more Chapter 11 filings.' " *Id.* (Citations omitted).

The court went on to note that it strongly disfavored "a judicial interpretation of the Bankruptcy Code that contravenes the substantial congressional policy favoring out of court consensual workouts." *Id.* Based on its analysis of the OID and unmatured interest issues, the Fifth Circuit Court of Appeals held that "the debt for debt face value exchange in the Pengo consensual workout did not create original issue discount for the purpose of Section 502(b)(2)." *Id.*

The undisputed facts in this case establish that the original consideration paid for the 8.5% debenture equalled the face amount of the Class A and Class B debentures combination exchanged therefore. Because the face value of the exchanged security equalled the original consideration paid for the underlying security, no discount occurred which would create unmatured interest or OID. As noted by the Fifth Circuit Court, an incorrect analysis of this issue results in a direct contravention of

the congressional policy underlying the Bankruptcy Code which favors out of court workouts. As such, the opinion of the Fifth Circuit Court of Appeals is correct and Licht's Petition for Writ of Certiorari should be denied.

II. No Conflict Exists Between The Circuit Courts Of Appeal On This Issue

In its opinion, the Fifth Circuit Court of Appeals noted that only one other Circuit Court of Appeals has addressed the issue of whether a debt for debt face value exchange in a consensual out of court restructuring generated unmatured interest within the meaning of Section 502(b)(2) of the Bankruptcy Code. *Pengo* at 548-49. In *Chateaugay,* the Second Circuit Court of Appeals dealt with the same issue of alleged OID and held that no new OID arose on a debt for debt exchange. *Chateaugay,* at 383. The *Chateaugay* court found that because the original debentures were issued at a discount the original issue discount carried over from the old debt to the new debt, but that no new OID was created by a face value debt for debt exchange. *Id.*

In its decision and opinion in this case, the Fifth Circuit Court of Appeals relied heavily on the reasoning of the Second Circuit's *Chateaugay* opinion. In fact, the Fifth Circuit specifically endorsed the reasoning of the Second Circuit in attempting to align the resolution of the OID issue with the favored policy of encouraging out of court workouts. *Pengo* at 549.

The Fifth Circuit Court of Appeals and the Second Circuit Court of Appeals are the only Circuit Courts of Appeal which have addressed the issue of whether a debt

for debt face value exchange in a consensual out of court restructuring creates unmatured interest in the form of original issue discount within the meaning of the Bankruptcy Code provision disallowing claims for unmatured interest. In both cases, the courts have found that such an exchange does not create unmatured interest which would be disallowed under the Bankruptcy Code.

It is important to note that in *Pengo*, the Fifth Circuit described a number of scenarios which it specifically refused to address by its decision in this case. *Pengo* at 549-51. First, the court refused to consider when an original issue of debt might create a discount and instead confined its decision to situations involving the exchange of debt instruments in a consensual out of court restructuring. *Id.* at 549-50. Likewise, the court refused to address a situation where holders exchange a debt instrument for a new debt instrument with a lower face amount. *Id.* at 550. The court refused to consider debt for equity exchanges as opposed to debt for debt exchanges. *Id.* In this area, the court specifically distinguished the case of *In Re Allegheny Int'l, Inc.*, 100 B.R. 247 (Bkrtcy. W.D. PA. 1989), because that case dealt with a debt for equity swap and not a debt for debt exchange. *Id.* Finally, the *Pengo* court drew a distinction between a debt for debt exchange in a bankruptcy case and the treatment of a debt for debt exchange under the Tax Code. *Id.* The court noted the differing policies underlying the Bankruptcy Code and Tax Code and, quoting the Second Circuit, stated that "the reasoning underlying the tax treatment of debt for debt exchanges simply does not apply in the bankruptcy context." *Id.* (Citations omitted).

In his Petition for Writ of Certiorari, Licht alleges that the Fifth Circuit's opinion in this case conflicts with a number of other opinions from both the United States Supreme Court and various Circuit Courts of Appeals. Each of these cases will be dealt with in turn.

Initially, Licht alleges that the Fifth Circuit's opinion in this case conflicts with this court's opinion in *Commissioner of Internal Revenue v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134 (1974). *National Alfalfa* is a case which deals with the tax consequences of a debt for equity exchange. *Id.* at 147. As noted by the Fifth Circuit, the different policies underlying the Tax Code and the Bankruptcy Code make tax cases such as *National Alfalfa* inapplicable to the instant case. *Pengo* at 550.

Even if *National Alfalfa* did apply to the instant case, however, it would not conflict with the Fifth Circuit's decision in this case. In *National Alfalfa*, this court upheld the finding of the tax court:

> That when a corporation issues obligations in exchange for its outstanding preferred, no discount arises if the amount that had been received upon the issuance of the preferred was equal to the face amount of the obligation issued upon the exchange.

National Alfalfa at 141-42. Because a full $1,000 was originally received by Pengo for the 8.5% debentures in this case, no discount arose when such debentures were exchanged for a Class A and Class B debenture combination with a total face value of $1,000. As such, even if applicable, *National Alfalfa* is not in conflict with the Fifth Circuit's opinion in this case.

Licht next alleges that the Fifth Circuit's opinion in this case is in conflict with a Tenth Circuit opinion in *Atchison T & S R.R. Co. v. United States*, 443 F.2d 147 (10th Cir. 1971). *Atchison*, however, has no bearing upon a debt for debt exchange in the bankruptcy context such as that involved in this matter. Rather, *Atchison* is a tax refund case. *Id.* at 148. As such, there can be no conflict between *Atchison* and the Fifth Circuit's opinion in the instant case.

Licht next alleges that the Fifth Circuit's opinion in this matter is in conflict with its previous decision in *Gulf M & O R.R. v. United States*, 579 F.2d 892 (5th Cir. 1978). Initially, like *National Alfalfa*, *Gulf* was a case involving the Tax Code and not the Bankruptcy Code. *Id.* Furthermore, in *Gulf*, a corporation exchanged preferred stock with a stated value of $100 for debentures with a face value of $100. *Id.* at 894-95. Thus, rather than a debt for debt exchange, the Fifth Circuit in *Gulf* was dealing with a debt for equity exchange. Further, in *Gulf*, the corporation asserted that there was a discount in the transaction because the market value of the preferred stock on the date of the exchange was approximately $11,800,000, and such stock was exchanged for debentures with a face value of approximately $18,700,000. *Id.* The Fifth Circuit stated that "the controlling test from *National Alfalfa* is whether 'some cost . . . of acquiring the use of capital' occurred, not whether additional capital was acquired." *Id.* at 896. After analyzing the transaction, the Fifth Circuit determined that Gulf actually incurred additional costs upon the exchange. *Id.* at 898. This decision was not based on the market value of the preferred stocks on the date of the exchange. Rather, the court followed *National*

Alfalfa by basing its decision on the fact that the $100 preferred stock was originally sold by the corporation for much less than $100. *Id.* This is distinguishable from the *Pengo* case in which the original debentures issued by Pengo were sold at their face value. Thus, *Gulf*, if applicable, is not in conflict with the Fifth Circuit's opinion in this matter.

Finally, Licht alleges that the Fifth Circuit's opinion in this matter is in conflict with the Ninth Circuit's holding in *In Re Nucorp Energy Sec. Litig.*, 772 F.2d 1486 (9th Cir. 1985). The *Nucorp* decision, however, bears no resemblance to the instant matter. In fact, in *Nucorp*, the court dealt with the issue of the transfer of ownership of a cause of action for violation of federal securities regulations to subsequent bond purchasers. *Id.* at 1488. Clearly, the facts of *Nucorp* are not applicable to the facts of the instant matter. As such, there can be no conflict between these two decisions.

As a final matter, Licht lists the case of *In Re Allegheny Int'l, Inc.*, 100 B.R. 247 (Bkrtcy. W.D. PA. 1989) as a related case to the instant matter. As the Fifth Circuit noted in its opinion in this matter, *Allegheny* was concerned with a pre-bankruptcy debt for equity swap, and not a debt for debt exchange. *Pengo* at 550. As such, the factual backgrounds of the cases are distinguishable and the holdings in the cases are not in conflict.

Licht has asserted in his Petition for Writ of Certiorari that this court should review the Fifth Circuit's opinion in the instant matter due to its conflict with opinions issuing from other courts. As demonstrated above, there is no conflict between the Fifth Circuit's

opinion in this case and any other case dealing with the issues herein involved. In fact, the only other Circuit Court of Appeals case which deals with a debt for debt face value exchange in a consensual out of court restructuring is in total agreement with the opinion in this matter. As such, Licht's Petition for Writ of Certiorari should be denied.

CONCLUSION

The United States Court of Appeals for the Fifth Circuit has issued a well reasoned and sound opinion that both supports and furthers the underlying policy of the Bankruptcy Code to encourage out of court workouts. By holding that a debt for debt face value exchange in a consensual out of court restructuring does not create unmatured interest in the form of original issue discount within the meaning of the Bankruptcy Code, the Fifth Circuit Court of Appeals has issued an opinion that is in compliance with the underlying purposes of the Bankruptcy Code and which is grounded in sound public policy. Furthermore, the opinion issued by the Fifth Circuit Court of Appeals does not conflict with any other Circuit Court opinion which has dealt with this factual situation. As such, this court should deny Licht's Petition

for Writ of Certiorari. The Respondent also requests all other relief to which this court may find it entitled.

Respectfully submitted,

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